Nos. 00-511, 00-555, 00-587, 00-590 and 00-602

In the Supreme Court of the United States

VERIZON COMMUNICATIONS, INC., ET AL., PETITIONERS

v.

FEDERAL COMMUNICATIONS COMMISSION, ET AL.

AND RELATED CASES

*ON WRITS OF CERTIORARI TO THE
UNITED STATES COURT OF APPEALS
FOR THE EIGHTH CIRCUIT*

**BRIEF FOR RESPONDENTS
FEDERAL COMMUNICATIONS COMMISSION AND
THE UNITED STATES**

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QUESTION PRESENTED

Whether the court of appeals erred in holding that neither the Takings Clause nor the Telecommunications Act of 1996 requires incorporation of an incumbent local exchange carrier's "historical" costs into the rates that it may charge new entrants for access to its network elements.

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The opinion of the court of appeals (No. 00-587 Pet. App. 1a-43a) is reported at 219 F.3d 744. The *Local Competition Order* of the Federal Communications Commission (FCC) is reported at 11 F.C.C.R. 19,392.

JURISDICTION

The judgment of the court of appeals was entered on July 18, 2000. Verizon's petition for a writ of certiorari in No. 00-511 was filed on October 4, 2000, and was granted on January 22, 2001. The jurisdiction of this Court rests on 28 U.S.C. 1254(1).

STATUTORY PROVISIONS INVOLVED

The relevant provisions of the Telecommunications Act of 1996 (1996 Act), Pub. L. No. 104-104, 110 Stat. 56, are reproduced in the appendix to our petition in No. 00-587 (U.S. Pet. App.) 104a-125a and in the Joint Appendix (J.A.) at 9-48. In referring to the provisions of the 1996 Act, we have cited the 1998 Supplement to the United States Code.

STATEMENT

1. a. Throughout most of the United States, local telephone service in each community has long been dominated by a single incumbent "local exchange carrier," or LEC. That incumbent LEC, whether a regional Bell company or an independent carrier, owns almost all of the loops (the wires that connect telephones to switches) in its service area, along with the switches (which direct calls to their destinations) and the transport trunks (which carry calls between switches). The incumbents' control over those facilities has solidified their de facto monopoly position in most local telecommunications markets. Indeed, even today, after years of efforts to open those markets to competition, incumbents still provide service over approximately 93% of local telephone lines. See Industry Analysis Division, FCC,

Local Telephone Competition: Status as of June 30, 2000, at 1 (2000); see also Industry Analysis Division, FCC, *Local Telephone Competition at the New Millennium*, Table 6 (2000) (as of December 1999, incumbents controlled approximately 94% of total local telecommunications revenues).

The barriers to entry into local telecommunications markets are different from, and vastly more formidable than, the barriers to entry into the long-distance market. It has been economically practicable for some long-distance carriers to build their own interexchange infrastructure—*e.g.*, to lay cable or build microwave networks connecting local calling areas to one another—because they can rely (albeit at a cost) on the LECs on either end of an interexchange call to route the call through the various switches and local loops from the call's origin to its destination. But, at least with current technology, it would be economically impracticable for even the largest prospective competitor to duplicate completely the functions of an incumbent LEC's entire network. And, without rights of interconnection, a potential competitor could not gradually enter the market through partial duplication of those functions; a new carrier would win few customers if its customers could call only one another and not customers on the incumbent LEC's separate (and completed) network.

b. "Until the 1990's, local phone service was thought to be a natural monopoly. * * * Technological advances, however, have made competition among multiple providers of local service seem possible." *AT&T* v. *Iowa Utils. Bd.* (*Iowa Utils. Bd. I*), 525 U.S. 366, 371 (1999). Congress enacted the Telecommunications Act of 1996 (1996 Act), Pub. L. No. 104-104, 110 Stat. 56, to open local telecommunications markets to full competition. Congress recognized that no prospective entrant could replicate, at least in the short term, all of an incumbent's existing local network infrastructure. Accordingly, in the local competition provisions of the 1996 Act, 47 U.S.C. 251-253, Congress provided the means for potential competitors to enter local markets by using the incumbents' networks in a variety of ways. See 47 U.S.C. 251(c)(2)-(4).

Central to the local competition provisions is Section 251(c)(3), which entitles a new entrant to gain "access" to (*i.e.*, to lease) an incumbent's "network elements," such as loops, switching capability, and other components and capabilities of the incumbent's network. 47 U.S.C. 251(c)(3); see also 47 U.S.C. 153(29) (defining "network element"). That provision permits new entrants, some of which may also have network elements of their own, to lease from an incumbent those elements that they need to provide services to their own customers.[1] The 1996 Act further permits new entrants to "interconnect" their own facilities with those in the incumbent's network "at any technically feasible point." See 47 U.S.C. 251(c)(2).

An incumbent may charge a new entrant for interconnection and access to network elements. If the incumbent and the new entrant cannot agree on those charges, the 1996 Act authorizes the state public utility commission, acting as arbitrator, to set the rates that the incumbent may charge.[2]

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[1] An incumbent's obligation to lease network elements to new entrants extends only to those elements designated by the FCC under Section 251(d)(2). That provision states that, "[i]n determining what network elements should be made available for purposes of" Section 251(c)(3), the FCC "shall consider, at a minimum," certain competitive standards. 47 U.S.C. 251(d)(2). With respect to most elements, the statutory standard that the FCC must consider is whether "the failure to provide access to such network elements would impair the ability of the telecommunications carrier seeking access to provide the services that it seeks to offer." 47 U.S.C. 251(d)(2)(B); see also 47 U.S.C. 251(d)(2)(A) (providing that, with respect to "proprietary" elements, the relevant standard is whether "access to such network elements * * * is necessary"). See note 6, *infra*.

[2] A state commission may opt out of that statutory role, in which case the FCC would resolve individual disputes between carriers over the

The state commissions must set rates that are "nondiscriminatory" and "based on the cost (determined without reference to a rate-of-return or other rate-based proceeding) of providing the interconnection or network element." 47 U.S.C. 252(d)(1).[3] The rates "may include a reasonable profit" for the incumbent. 47 U.S.C. 252(d)(1). In setting such rates, the state commissions must follow the FCC's pricing rules that give content to that statutory standard. See *Iowa Utils. Bd. I*, 525 U.S. at 383-385.

The 1996 Act also conferred significant benefits on incumbent LECs. For example, the 1996 Act "relieves the [regional Bell companies] of several of the burdens imposed by the [1982 AT&T consent decree], particularly by prescribing in [47 U.S.C.] § 271 a method whereby [they] can achieve a long-sought-after presence in the long distance market." *BellSouth Corp.* v. *FCC*, 162 F.3d 678, 690 (D.C. Cir. 1998) (emphasis and citation omitted); see also 1996 Act, Title VI, § 601(a)(2), 110 Stat. 143 (superseding GTE consent decree). The 1996 Act further entitles incumbent LECs, like other telecommunications carriers, to invoke its local competition provisions to expand their operations into new geo-

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rates to be charged for providing interconnection and access to network elements. See 47 U.S.C. 252(e)(5).

[3] Section 252(d)(1), titled "Interconnection and network element charges," provides in full:

> Determinations by a State commission of the just and reasonable rate for the interconnection of facilities and equipment for purposes of subsection (c)(2) of section 251 of this title, and the just and reasonable rate for network elements for purposes of subsection (c)(3) of such section—
>
> (A) shall be—
>
> (i) based on the cost (determined without reference to a rate-of-return or other rate-based proceeding) of providing the interconnection or network element (whichever is applicable), and
>
> (ii) nondiscriminatory, and
>
> (B) may include a reasonable profit.

graphic areas and compete for the customers of other incumbents.

2. In August 1996, the FCC issued its initial order addressing the most basic issues involving local competition arising under the 1996 Act. See *In re Implementation of the Local Competition Provisions in the Telecommunications Act of 1996*, *First Report and Order* (*Local Competition Order*), 11 F.C.C.R. 15,499 (1996). A cornerstone of that order is the FCC's choice of the cost methodology—"total element long-run incremental cost," or TELRIC—that state public utility commissions are to employ in resolving disputes between carriers about the "cost[s]" that Section 252(d)(1) allows the incumbent to recover from the new entrant for providing interconnection and network elements. See *Local Competition Order* (paras. 674-703), J.A. 376-396.

TELRIC embodies a "forward-looking" approach to calculating the cost of providing network elements and interconnection. The essential objective of any forward-looking methodology is to determine what it would cost in today's market to replace the functions of an asset that make it useful. That is the asset's "forward-looking" cost (also known as its "replacement" or "economic" cost), as distinguished from the cost of duplicating the asset in every physical particular. Thus, under a forward-looking methodology, if an incumbent bought an analog switch in 1985 at a fixed cost of $150 per line, and an efficient carrier would address the same business needs today by purchasing a digital switch at a fixed cost of $100 per line (more efficient digital switches have supplanted analog switches in the market), the latter figure is the appropriate basis for determining what a new entrant would pay the incumbent to lease switching capacity. Similarly, if a loop cost $100 to install in 1985 but would cost $150 to install today (because, for example, labor costs have increased), the rate for leasing that loop would be based on the higher current cost figure.

In asking what it would cost to replace the functions that make an asset valuable, a forward-looking cost methodology requires an inquiry into currently available substitutes—including assets that perform the same functions as the asset in the incumbent's network, but that do not resemble the asset in all respects (*e.g.*, because they embody more efficient technology than the original asset). Some incumbents urged the FCC to foreclose any consideration of currently available substitutes in TELRIC. The FCC rejected the incumbents' suggestion as arbitrarily limiting the inquiry into the forward-looking cost of replacing an asset's useful functions in today's market. See *Local Competition Order* (paras. 683-685), J.A. 382-384.[4]

The forward-looking purchase price of an asset is only one variable in the TELRIC compensation calculus. TELRIC also takes into account (1) the duration of an element's useful life, as reflected in an appropriate economic depreciation schedule; (2) the cost of capital (*i.e.*, the required return, or profit, on investment); and (3) various types of expenses, such as maintenance expenses. See *Local Competition Order* (para. 703), J.A. 396. One of TELRIC's principal objectives is to ensure an incumbent's opportunity, when leasing network elements to others, to recover the full forward-looking cost of those elements (including the cost of capital) over their useful lives.

Many of the essential details of implementing TELRIC are left to state public utility commissions. For example, the FCC did not set depreciation schedules itself; rather, state

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4 The FCC determined that TELRIC should, however, take as given the incumbent's existing wire centers (*i.e.*, its switch locations), thereby confining the inquiry to efficient alternatives that are compatible with the basic geographical design of the existing network. *Local Competition Order* (para. 685), J.A. 383-384. The FCC observed that such a limitation would give new entrants additional incentives to save costs by constructing facilities of their own embodying "more efficient network configurations." *Ibid.*

commissions determine, among other things, how best to adopt "specific depreciation rate adjustments that reflect expected asset values over time," including, where relevant, "expected declines in the value of capital goods." *Local Competition Order* (para. 686), J.A. 384-385. Similarly, the state commissions have wide discretion to determine the appropriate cost of capital (or return on investment); they are authorized to increase the cost of capital, if warranted, to compensate incumbents for the risk of increased competition. *Local Competition Order* (para. 702), J.A. 395-396.

The FCC rejected the argument of several incumbent LECs that the 1996 Act entitles them to rates for interconnection and network elements that are based on the "historical" (or "embedded") costs reflected on their accounting books. The FCC recognized that those costs could be either higher or lower than forward-looking costs. *Local Competition Order* (para. 705), J.A. 398-399. The FCC reasoned that the use of historical costs would be economically arbitrary and would frustrate the competitive objectives of the 1996 Act. See *Local Competition Order* (paras. 704-711), J.A. 397-403.[5]

3. In 1996 and 1997, the Eighth Circuit stayed and then invalidated the FCC's pricing rules on the ground that the 1996 Act gives state public utility commissions, not the FCC, general jurisdiction to interpret the pricing provisions of Sections 251 and 252. *Iowa Utils. Bd.* v. *FCC*, 120 F.3d 753,

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[5] At the same time that the FCC promulgated the pricing rules discussed in the text, the FCC also promulgated other rules, which have come to be known as the "combinations" rules. See *Local Competition Order* (paras. 292-297), J.A. 295-299. In *Iowa Utilities Board I*, this Court reversed the Eighth Circuit's decision invalidating one of those rules, 47 C.F.R. 51.315(b); on remand, the Eighth Circuit again invalidated others of those rules, 47 C.F.R. 51.315(c)-(f), and this Court granted certiorari to consider that aspect of the court of appeals' decision. We address the combinations rule question in our brief as petitioners in this consolidated case.

794-800 (1997). The Eighth Circuit's jurisdictional orders remained in effect until early 1999. During that period, the great majority of state commissions voluntarily applied the FCC's basic forward-looking methodology in adjudicating disputes between incumbents and new entrants over the rates to be charged for interconnection and network elements. See note 12, *infra*. In January 1999, this Court reversed the Eighth Circuit's jurisdictional ruling, holding that the FCC has statutory authority to establish national pricing standards under Sections 251 and 252. *Iowa Utils. Bd. I*, 525 U.S. at 376-385. The Court remanded the case to the Eighth Circuit to address (among other things) the substantive validity of the FCC's cost methodology.[6]

4. In July 2000, the Eighth Circuit issued its decision on remand. The court upheld the FCC's authority to prescribe a pricing methodology based on forward-looking costs, invalidated a key component of the particular methodology that the FCC adopted, and rejected, as premature, the incumbents' Takings Clause challenge to the methodology. U.S. Pet. App. 10a-18a.

First, the court of appeals rejected the incumbents' argument that, in providing that the rates that they may charge new entrants for interconnection and network elements are to be based on "cost," Congress dictated a methodology based on historical cost. The court concluded that "the term 'cost,' as it is used in the statute, is ambiguous, and

[6] This Court separately upheld several of the FCC's rules on the merits but invalidated a portion of the FCC's original implementation of the "necessary" and "impair" standards of Section 251(d)(2), see note 1, *supra*, and remanded to the FCC for further rulemaking. See *Iowa Utils. Bd. I*, 525 U.S. at 387-392. The FCC issued an order on remand in December 1999. See *In re Implementation of the Local Competition Provisions of the Telecommunications Act of 1996, Third Report and Order and Fourth Further Notice of Proposed Rulemaking*, 15 F.C.C.R. 3696 (1999), petitions for review pending *sub nom. United States Telecomm. Ass'n* v. *FCC*, Nos. 00-1015 et al. (D.C. Cir. Jan. 19, 2000).

Congress has not spoken directly on the meaning of the word in this context." U.S. Pet. App. 11a. The court therefore recognized that the FCC has the authority to make reasonable rules to resolve any such ambiguity. *Id.* at 11a-12a (citing *Chevron U.S.A. Inc.* v. *NRDC, Inc.*, 467 U.S. 837, 842-843 (1984)). The court then concluded that the FCC's adoption of a methodology based on forward-looking costs was reasonable. *Id.* at 12a. The court noted that "[f]orward-looking costs have been recognized as promoting a competitive environment which is one of the stated purposes of the [1996] Act." *Ibid.* The court found that the FCC had adequately explained its conclusion that a methodology based on forward-looking costs "would best ensure efficient investment decisions and competitive entry," and thus "implement the new competitive goals of the Act." *Ibid.*

Second, the court of appeals invalidated the FCC's rule specifying that, apart from the "wire center" exception (see note 4, *supra*), the forward-looking cost of an element should be "based on the use of the most efficient telecommunications technology currently available and the lowest cost network configuration," 47 C.F.R. 51.505(b)(1). U.S. Pet. App. 6a-10a. The court held that the regulation is contrary to "the plain meaning" of Section 252(d)(1) and thus does not satisfy step one of this Court's *Chevron* analysis. *Id.* at 8a; see also *id.* at 4a.[7]

Third, the court of appeals rejected, as premature, the incumbents' assertion that the FCC's methodology, including its consideration of forward-looking costs, raises a serious Fifth Amendment takings issue that the 1996 Act should be construed to avoid. The court concluded that "the present takings claim is not ripe for review" because, "[u]ntil the actual rates are established" by state public utility commissions, "we cannot conclude whether the impact of

[7] That aspect of the court of appeals' opinion is among the questions presented by our petition in this consolidated case.

TELRIC driven rates will constitute a taking." Pet. App. 17a. The court observed that a mere "possibility that a regulatory program may result in a taking does not justify the use of a narrowing construction." *Id.* at 17a-18a (citing *United States* v. *Riverside Bayview Homes, Inc.*, 474 U.S. 121, 128-129 (1985)).

5. The local competition provisions of the 1996 Act are complemented by 47 U.S.C. 254, the provision of the 1996 Act relating to "universal service." For many years, federal and state regulators sought to ensure low rates for subscribers in "high cost" areas through a variety of implicit and explicit cross-subsidy mechanisms. For example, incumbent LECs often charged retail rates to customers in densely populated urban areas that well exceeded the cost of serving those customers; those revenues were then used to subsidize the retail rates charged customers in remote rural areas that are much more expensive to serve. Congress recognized that the emergence of local competition would tend to erode the source of such cross-subsidies, as new entrants won the business of customers who would otherwise pay above-cost rates to incumbents. A central objective of Section 254 is to phase out the implicit cross-subsidies and replace them with explicit and competitively neutral funding mechanisms supported by all providers of telecommunications services, including new entrants that provide service through the use of an incumbent's network elements under Section 251(c)(3).

In 1997, the FCC issued rules implementing Section 254 and, among its determinations, chose a forward-looking cost methodology similar to TELRIC as a key factor in determining the level of federal funding to supplement state efforts to subsidize affordable service to high cost areas. See *In re Federal-State Joint Bd. on Universal Serv., Report and Order*, 12 F.C.C.R. 8776 (1997). In 1999, the Fifth Circuit adjudicated various challenges to that Order. *Texas Office of Pub. Util. Counsel* v. *FCC*, 183 F.3d 393 (1999).

Among its holdings, that court rejected the argument of certain incumbent LECs that construing Section 254 to permit the use of a methodology based on forward-looking costs is barred by the Takings Clause. *Id.* at 413 & n.14. In June 2000, this Court granted a petition for a writ of certiorari on that issue, filed by GTE, one of the corporate predecessors (along with Bell Atlantic) to Verizon Communications, Inc. *GTE Serv. Corp.* v. *FCC*, 530 U.S. 1213 (No. 99-1244). On November 2, 2000, the Court granted Verizon's unopposed motion to dismiss that case. 121 S. Ct. 423.

SUMMARY OF ARGUMENT

In order to stimulate competition in local telecommunications markets, Congress, in the 1996 Act, gave new entrants the right to interconnect with, and to lease elements of, incumbents' existing networks. 47 U.S.C. 252(c)(2) and (3). Congress provided that incumbents would be compensated for doing so at rates based on "the cost * * * of providing the interconnection or network element." 47 U.S.C. 252(d)(1)(A). The FCC, in the rulemaking prescribed by the 1996 Act, determined that such rates should be based on forward-looking costs—*i.e.*, the cost of obtaining the features or functions of a network element that make it useful—rather than the historical costs reflected on incumbents' accounting books. The FCC reasoned that setting network element rates on the basis of forward-looking costs, which emulate rational economic choices in a competitive market, would send appropriate signals for entry, investment, and pricing in markets moving from monopoly to competition. The FCC's choice of a methodology based on forward-looking costs is reasonable and is consistent with the text, structure, and purposes of the 1996 Act.

A. In so holding, the court of appeals recognized that "the term 'cost,' as it is used in the [1996 Act], is ambiguous, and Congress has not spoken directly on the meaning of the word in this context," U.S. Pet. App. 11a. Accordingly, the FCC is authorized to adopt reasonable rules to resolve that ambiguity. See *Chevron U.S.A. Inc.* v. *NRDC, Inc.*, 467 U.S. 837, 842-843 (1984).

1. Verizon nonetheless contends, relying on dictionary definitions, regulatory practice, and other provisions of the 1996 Act, that the word "cost" in 47 U.S.C. 252(d)(1) can refer *only* to historical cost. Verizon is mistaken.

First, the dictionary definitions on which Verizon relies, which equate "cost" with the amount paid or to be paid for an item, do not contain any temporal restriction. Those definitions could equally refer to the amount that would be paid for the item today (*i.e.*, the forward-looking cost), as opposed to the amount that was paid for the item in the past (*i.e.*, the historical cost).

Second, at different times and in different contexts, regulators have used both forward-looking and historical costs to set rates, and this Court has recognized that neither approach is compelled either by the Constitution or by various statutes authorizing ratemaking in similarly general terms. Indeed, in the particular context of opening local telecommunications markets to competition, state regulators had already concluded, in advance of the enactment of the 1996 Act, that forward-looking costs should be used to set the rates at which incumbents provide facilities to new entrants. It is unlikely that Congress intended to foreclose such an approach in the new competitive environment contemplated by the 1996 Act.

Third, the other provisions of the 1996 Act on which Verizon relies do not dictate any particular construction of the word "cost" in Section 252(d)(1). Rather, those provisions provide further indication of the considerable discretion that Congress vested in the FCC to implement the Act. For example, the statutory provision that network element rates "*may* include a reasonable profit," 47 U.S.C. 252(d)(1)(B) (emphasis added), not only does not limit the FCC to adopting a particular definition of "cost," since the concept of profit is equally relevant to forward-looking and historical approaches; the provision also reflects that Congress intended that the FCC would make fundamental choices about the rate methodology, including choices concerning whether, or how, profit is to be taken into account.

2. Nor does the doctrine of constitutional avoidance require a construction of Section 252(d)(1) that reads the term "cost" to refer exclusively to historical cost. Verizon has not demonstrated that the FCC's forward-looking cost methodology presents serious Takings Clause concerns. And that is true whether one considers the impact of the methodology on incumbents' overall returns, as this Court's precedents indicate, or on incumbents' compensation for network elements standing alone.

In a series of cases, including *Duquesne Light Co.* v. *Barasch*, 488 U.S. 299, 312, 314 (1989), the Court has explained that a change in regulatory methodology—including one that denies a regulated company recovery of prudently incurred historical costs—constitutes a taking only if "the net effect" of the change is to "leav[e] [the company] insufficient operating capital" or "imped[e] [its] ability to raise future capital." No such "net effect" has been shown here. To the contrary, the incumbents have continued to enjoy generous returns, on both their interstate and intrastate activities, in the years since they were required to lease network elements at rates based on forward-looking costs.

In any event, even if one focuses on the adequacy of the incumbents' compensation for leasing network elements in isolation, Verizon has offered no cogent reason to conclude that the incumbents will receive constitutionally inadequate compensation under a methodology based on forward-looking costs. Under traditional just compensation principles, when the government commits private property to public use, it is required to pay the owner the fair market value of the property. The government is not required to pay the owner whatever higher price the property might have fetched in the past. The concept of fair market value is closely akin to the concept of forward-looking cost; both focus on the cost of an item in the current market, which may reflect changes in technology, production, or other factors since the item was originally placed into service.

Verizon also asserts that the FCC's methodology will leave the incumbents with "stranded investment" for which they will never be fully compensated. But *Duquesne* recognizes that the Constitution does not prohibit all regulatory changes that produce stranded investment, but only those that have a confiscatory effect on a company's net returns. The FCC found in this proceeding, moreover, that the incumbents' claims of stranded investment were unsubstantiated and were based on unrealistic assumptions about the rate of competitive entry into local markets. The passage of time has given no greater validity to the incumbents' claims. In any event, the FCC has expressly preserved the option of providing a remedy for stranded investment, if the incumbents demonstrate the need for one.

B. The FCC's decision to adopt a forward-looking methodology for setting network element rates satisfies the reasoned decisionmaking standards of the Administrative Procedure Act, 5 U.S.C. 701 *et seq.* The FCC reasonably concluded, and adequately explained, that a forward-looking methodology would most effectively implement Congress's purposes underlying the 1996 Act—*i.e.*, to expedite the development of competition in local telecommunications markets, to facilitate the efficient use of existing network facilities, and to encourage new entrants to make economically rational choices about whether, or how, to enter local markets. At the same time, the FCC recognized that the use of a historical cost methodology could impair the development of competition; in those circumstances where historical costs exceed forward-looking costs, for example, competitors could be deterred from entering the market or induced to construct inefficient, duplicative facilities.

Contrary to Verizon's assertions, the FCC's choice of a forward-looking methodology does not undermine Congress's goal of encouraging efficient facilities-based competition. It was, after all, Congress, not the FCC, that made the decision to accelerate competition in local telecommunications markets by enabling new entrants to lease some elements of incumbents' networks, as many new entrants must in order to develop competitive services. As the FCC recognized, a historical-cost approach would arbitrarily impede new entrants' ability to use that entry vehicle. Moreover, as experience since the adoption of the 1996 Act indicates, new entrants are offering competing local telecommunications services through facilities that they have purchased or built, as well as through facilities leased from incumbents and through resale. Indeed, new entrants have strong practical incentives to avoid having to rely on incumbents to provide the facilities on which they depend to serve their customers.

Finally, there is no merit to Verizon's suggestion that a forward-looking approach is so "administratively unworkable" that the FCC lacked discretion to adopt it. As explained above, the FCC concluded that a forward-looking approach is far superior to a historical approach for measuring the costs relevant here—the costs on which incumbents would base charges for network elements in a truly competitive market. Moreover, as demonstrated by decades of experience, a historical cost approach, no less than a forward-looking one, presents significant administrative difficulties. Under a historical approach, no less than under other approaches, regulators would have to make complex judgment calls about appropriate depreciation rates, rates of return, and allocations of joint and common costs to various aspects of the network.

ARGUMENT

I. THE FCC REASONABLY CONSTRUED SECTION 252(D)(1) OF THE 1996 ACT TO PERMIT THE USE OF FORWARD-LOOKING COSTS TO DETERMINE NETWORK ELEMENT PRICES

A. The FCC's Construction Of "Cost" Is Consistent With The Language, Structure, And Purposes Of The Act

1. In the 1996 Act, Congress provided that the "just and reasonable rate" at which an incumbent LEC may lease a network element to a new entrant is a rate "based on the cost * * * of providing the * * * network element." 47 U.S.C. 252(d)(1)(A). As the court of appeals recognized, Congress did not itself prescribe how that "cost" is to be determined; rather, Congress left it to the FCC to determine which of the various possible methods for measuring "cost" would best serve the purposes of the Act. See U.S. Pet. App. 11a ("We conclude the term 'cost,' as it is used in the statute, is ambiguous, and Congress has not spoken directly on the meaning of the word in this context."); see generally *AT&T* v. *Iowa Utils. Bd.* (*Iowa Utils. Bd. I*), 525 U.S. 366, 397 (1999) (observing that the 1996 Act "is in many important respects a model of ambiguity"—ambiguity that "Congress [was] well aware" would "be resolved by the implementing agency").

In making that determination, the FCC considered the comments of economists and other experts as well as the experience of those States that had already moved to open their own local telecommunications markets to competition. The FCC concluded that the appropriate "cost * * * of providing" a network element, for purposes of Section 252(d)(1), is the forward-looking cost of that element—*i.e.*, the cost in today's market of obtaining the features or functions of the element that make it useful. The FCC noted that the forward-looking cost of an element may, depending upon the individual context, be either higher or lower than its historical cost. See *Local Competition Order* (para. 705), J.A. 398-399.[8]

The FCC found support for its adoption of a forward-looking cost methodology in the purposes of the 1996 Act: to stimulate the expeditious development of competition in local telecommunications markets; to ensure the efficient use of existing network facilities, many of which embody significant economies of scale and scope; and to encourage new entrants to make economically rational decisions about whether, or how, to enter a given market. The FCC explained that setting prices under a forward-looking methodology emulates rational economic behavior in a competitive market, because a firm considers forward-looking costs, not historical costs, in making decisions about entry, expansion, and price. See *Local Competition Order* (paras. 620, 679, 740), J.A. 327-328, 379-380, 422-423; see also *Duquesne Light Co.* v. *Barasch*, 488 U.S. 299, 308 (1989) (forward-looking costs "mimic[] the operation of the competitive market"); *MCI Communications Corp.* v. *AT&T*, 708 F.2d 1081, 1116-1117 (7th Cir.) ("[I]t is current and anticipated cost, rather than historical cost that is relevant to business decisions to enter markets."), cert. denied, 464 U.S. 891 (1983). The FCC thus concluded that the forward-looking methodology embodied in TELRIC would send appropriate signals for entry, investment, and pricing to potential competitors in local telecommunications

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[8] Thus, although "[t]he FCC fully understood that TELRIC rates would be below historical costs" (Verizon Pet. Br. 28) in many instances, the FCC also understood that TELRIC rates could be above historical costs depending upon individual circumstances. Indeed, when the Iowa Utilities Board challenged the FCC's jurisdiction to set prices for network elements, it expressed concern that TELRIC would produce higher, not lower, network element rates in Iowa than would a historical cost methodology. See Mot. of Iowa Utils. Bd. for Stay at 9, *Iowa Utils. Bd.* v. *FCC*, No. 96-3321 (8th Cir. Sept. 19, 1996).

markets. See *Local Competition Order* (paras. 620, 630), J.A. 327-328, 333-334.

2. Verizon nonetheless contends (Verizon Pet. Br. 19-23) that the term "cost," as used in Section 252(d)(1), must be construed, under step one of *Chevron U.S.A. Inc.* v. *NRDC, Inc.*, 467 U.S. 837, 842-843 (1984), to refer exclusively to historical costs. Verizon asserts that its preferred reading is compelled by dictionary definitions, traditional regulatory usage, and statutory structure. The court of appeals correctly rejected that claim. See U.S. Pet. App. 10a-14a.

a. Verizon first attempts to read a historical component into dictionary definitions describing "cost" as, for example, "the amount or equivalent paid or given or charged or engaged to be paid or given for anything." Verizon Pet. Br. 19. But such conventional definitions accommodate forward-looking and historical interpretations with equal ease. Those definitions do not specify whether the relevant "cost" is an amount that would be paid or charged today to provide network elements (*i.e.*, the forward-looking cost) or an amount that was paid or charged in the past (*i.e.*, the historical cost).

Courts and commentators have recognized that the word "cost" is "one of equivocal meaning," *Strickland* v. *Commissioner, Me. Dep't of Human Servs.*, 48 F.3d 12, 19 (1st Cir.) (quoting 20 C.J.S. *Cost* (1940)), cert. denied, 516 U.S. 850 (1995), which may encompass both forward-looking and historical costs. See, *e.g.*, *MCI Communications*, 708 F.2d at 1116-1117 (observing that methodologies based on forward-looking cost (*e.g.*, "long-run incremental cost") and historical cost (*e.g.*, "fully distributed cost") "can be viewed as simply different ways of defining the average total cost ('ATC') of a particular product or service") (emphasis omitted). As Justice Breyer noted in his separate opinion in *Iowa Utilities Board I*, "general terms" of the sort used in the 1996 Act to articulate the network element pricing standard—such as the term "based on * * * cost" in Section 252(d)(1)—"give ratesetting commissions broad methodological leeway" and "say little about the 'method employed' to determine a particular rate." 525 U.S. at 423 (Breyer, J., concurring in part and dissenting in part).[9]

It was particularly reasonable for the FCC to construe the 1996 Act to authorize a forward-looking cost methodology, because, under the plain language of Section 252(d)(1), rates are to be based "on the cost (determined without reference to a rate-of-return or other rate-based proceeding) of providing the interconnection or network element." The "cost * * * of providing" a network element—such as a local loop connecting a house to a telephone switch—is most reasonably construed as the cost of procuring that element on today's market. It cannot as readily be construed as the cost that an incumbent happened to pay for its facilities many years in the past.

b. Contrary to Verizon's assertion, regulatory history supplies no single definitive meaning of "cost." Indeed, one of the treatises upon which Verizon relies for a fixed reading of "cost" to mean historical cost acknowledges that, in the utility ratemaking context in particular, " '[c]ost' * * * is a word of many meanings"—including, specifically, both historical "original-cost" and forward-looking "reproduction-cost." James C. Bonbright et al., *Principles of Public Utility Rates* 109 (2d ed. 1988). Thus, although the term "cost" today is not confined to forward-looking cost,[10] the "view of

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[9] Accord, *e.g.*, *National Ass'n of Greeting Card Publishers* v. *United States Postal Serv.*, 462 U.S. 810, 832 (1983) (observing that the statutory term "attributable costs," which Congress directed the Postal Service to consider in setting postal rates, "has no technical meaning" and "connotes the use of judgment" by the expert agency); *Alabama Elec. Coop., Inc.* v. *FERC*, 684 F.2d 20, 27 (D.C. Cir. 1982) (noting that "[c]ost itself is an inexact standard").

[10] Ratemaking based upon "fair value," a version of forward-looking cost, was once thought to be constitutionally required. See *Smyth* v. *Ames*, 169 U.S. 466 (1898); see also Richard J. Pierce, Jr., *Public Utility*

historic cost as the apodictically indicated measure of 'actual cost,' is not * * * supported by the applicable law." *City of Los Angeles Dep't of Airports* v. *United States Dep't of Transp.*, 103 F.3d 1027, 1032 (D.C. Cir. 1997).

Moreover, as we previously noted (see U.S. Pet. Br. 24-25), regulators, with court approval, have long employed methodologies based on forward-looking costs. In the 1980s, for example, the Interstate Commerce Commission (ICC) adopted a forward-looking cost methodology, based on "most efficient" alternatives, to determine the maximum rate that a market-dominant railroad could charge a coal shipper that was the "captive" of that railroad.[11] See also, *e.g.*, *Mobil Oil Exploration & Producing S.E., Inc.* v. *United Distribution Cos.*, 498 U.S. 211, 219, 221-226 (1991) (upholding FERC's "replacement-cost-based method" of pricing existing natural

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Regulatory Takings: Should the Judiciary Attempt to Police the Political Institutions?, 77 Geo. L.J. 2031 & n.5 (1989) (cataloguing cases).

[11] Under the ICC's standard, the railroad could charge the captive shipper no more than the "stand alone" cost of transporting the coal, defined as the forward-looking cost that the shipper itself would incur were it to transport the coal to its destination using the most efficient railroad system that could be configured to accomplish that task. See Ex Parte No. 347 (Sub-No. 1), *Coal Rate Guidelines, Nationwide*, 1 I.C.C.2d 520, 542-546 (1985), aff'd *sub nom. Consolidated Rail Corp.* v. *United States*, 812 F.2d 1444, 1451, 1457 (3d Cir. 1987); see also Ex Parte No. 347 (Sub-No. 1), *Coal Rate Guidelines, Nationwide* (unpublished decision issued Feb. 8, 1983), slip op. 10-13 (delineating substantially similar interim standard). The D.C. Circuit (in an opinion joined by then-Judge Scalia) upheld the ICC's use of that methodology. The court reasoned that, although the methodology "deals with hypothetical and not actual transportation situations, it provides an appropriate analytical tool for determining whether a return on noncompetitive traffic 'properly reflects the high demand for the service, but is not set at an unreasonably high or "monopoly" level.'" *Potomac Elec. Power Co.* v. *ICC*, 744 F.2d 185, 193-194 (D.C. Cir. 1984) (quoting interim ICC Guidelines); see also *Consolidated Rail Corp.*, 812 F.2d at 1453-1457 (affirming in full final ICC guidelines); *Burlington N. R.R.* v. *Surface Transp. Bd.*, 114 F.3d 206, 212-215 (D.C. Cir. 1997) (affirming application of those guidelines).

gas, which "approximated * * * the current cost of finding new gas fields, drilling new wells, and producing new gas").

In the years preceding the enactment of the 1996 Act, a number of state public utility commissions, in acting to open their own local telecommunications markets to competition, recognized the appropriateness of using forward-looking costs as the basis for determining the rates at which incumbents could be required to open their facilities to new entrants. See *Local Competition Order* (paras. 631, 681), J.A. 334-336, 381.[12] The European Commission has endorsed a forward-looking methodology similar to TELRIC—based on a model hypothesizing "an efficient operator employing modern technology"—as a means of opening European telecommunications markets to competition.[13] It is exceedingly

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[12] Moreover, during the period from 1996 through early 1999 when the FCC's pricing rules were stayed and then vacated by the Eighth Circuit on jurisdictional grounds, the overwhelming majority of state commissions independently and voluntarily embraced the essentials of TELRIC in their implementation of the local competition provisions of the 1996 Act. See Peter W. Huber, Michael K. Kellogg & John Thorne, *Federal Telecommunications Law* § 2.4.4.1, at 185 (2d ed. 1999) ("While the *Iowa Utilities Board* case was being litigated, most states used their price-setting authority in ways closely following the FCC models."). The federal courts have consistently endorsed that choice on the merits in their review of the state commissions' actions. See, *e.g.*, *GTE S. Inc.* v. *Morrison*, 6 F. Supp. 2d 517, 528-530 (E.D. Va. 1998), aff'd on other grounds, 199 F.3d 733, 742-744, 749 (4th Cir. 1999); *Bell Atl.-Del., Inc.* v. *McMahon*, 80 F. Supp. 2d 218, 235-236 (D. Del. 2000).

[13] See *Commission Recommendation on Interconnection in a Liberalised Telecommunications Market (Pt. 1, Interconnection Pricing)*, O.J. 1998 L073/42 ("Interconnection costs should be calculated on the basis of forward-looking long run average incremental costs, since these costs closely approximate those of an efficient operator employing modern technology."); see also Hank Intven, Jeremy Oliver & Edgardo Sepulveda, *Telecommunications Regulation Handboook* 3-25 (World Bank 2000) ("[T]oday most regulators and experts generally agree that the ideal approach for calculating the level of interconnection charges would be one based on forward-looking costs of supplying the relevant facilities and

unlikely that Congress intended to foreclose the FCC from adopting the very methodology that other regulators had found singularly appropriate to promote competition in the telecommunications industry and other regulated industries.

c. The structure of the 1996 Act's local competition provisions does not, as Verizon suggests, demand that "cost" in Section 252(d)(1) be read to mean "historical cost." Indeed, the very provisions on which Verizon relies suggest, if anything, that Congress intended to vest the FCC with broad discretion in selecting an appropriate cost methodology.

First, Verizon claims that reading "cost" as "historical cost" is necessary to give meaning to Section 252(d)(1)(B), which states that rates for interconnection and network elements "may include a reasonable profit." Verizon Pet. Br. 20. That is so, Verizon asserts, because "profit" generally means an excess in returns over costs, while the Order at issue here viewed profit as one component of forward-looking costs themselves, leaving no independent significance to the separate statutory reference to "profit." *Id.* at 21.

As the court of appeals recognized, however, "[a] 'profit' can be made whether a historical cost or forward-looking cost methodology is used." U.S. Pet. App. 13a. Verizon's arguments turn not on a difference between historical costs and forward-looking costs, but on a difference between two permissible characterizations of "profit," each of which is equally applicable to a historical cost regime or a forward-looking cost regime. Under either regime, "profits" may be characterized as either (1) the recovery of revenues in excess of (historical or forward-looking) costs, with costs defined to exclude the opportunity costs represented by the decision to invest capital in telecommunications plant rather than elsewhere or (2) the recovery of a particular (historical or

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services."); *id.* at 3-23 (noting countries that have adopted such an approach).

forward-looking) cost itself, *i.e.*, the opportunity cost of capital. See *Local Competition Order* (paras. 699-703), J.A. 393-396. The FCC's description of a "reasonable profit" as the recovery of the cost of capital (along with all other relevant costs) under a forward-looking regime reflects the latter characterization. But that does not mean that the FCC was reading the reference to "profit" out of Section 252(d)(1).

Moreover, as the court of appeals observed, Congress's "use of the word 'may' [in Section 252(d)(1)(B)] indicates that the inclusion of a reasonable profit is not mandatory but permitted." U.S. Pet. App. 13a. Such discretionary language provides additional support for the conclusion that Congress was not itself dictating any particular pricing methodology for network elements. Rather, Congress sought to leave to the FCC the task of formulating the details of the pricing methodology, specifically including the question of whether, or how, profit is to be taken into account.

Second, Verizon contends that the accelerated implementation schedule that Congress established with respect to the local competition provisions of the 1996 Act, see 47 U.S.C. 251(d)(1), and the prohibition on the use of rate-of-return or other rate-based proceedings in establishing rates, see 47 U.S.C. 252(d)(1), create the "strong inference * * * that 'cost' refers to something already established and readily available, *i.e.*, historical cost as documented on incumbents' books." Verizon Pet. Br. 22. Both provisions, to the extent that they bear on the matter at all, militate against Verizon's construction of "cost."

Section 251(d)(1)'s directive that the FCC complete within six months "all actions necessary to establish regulations to implement the requirements of this section" reflects Congress's intent to expedite competitive entry into local markets. See *Local Competition Order* (para. 704), J.A. 397-398. The FCC's construction of "cost" advances that objective better than does Verizon's construction. As the FCC concluded, setting rates for network elements on the basis of forward-looking costs will stimulate the development of efficient competition, while setting rates on the basis of historical costs would retard and distort such competition. See *Local Competition Order* (paras. 620, 705), J.A. 327-328, 398-399.

The parenthetical restriction in Section 252(d)(1)(A)(i), which requires network element rates to be "determined without reference to a rate-of-return or other rate-based proceeding," "does not further define the type of costs that may be considered." *Local Competition Order* (para. 704), J.A. 397-398. But that provision does contemplate some departure from traditional forms of ratemaking for telephone companies, which had been conducted pursuant to historic cost-based "rate-of-return or other rate-based proceedings." In any event, Verizon's reliance on that parenthetical restriction starts from the false premise that the historical costs of network elements (*e.g.*, network "features, functions, and capabilities," 47 U.S.C. 153(29)) were "already established and readily available" on incumbents' accounting books, and thus could be applied in streamlined ratemaking proceedings. See Verizon Pet. Br. 22. In fact, historical cost data in the telecommunications industry traditionally focused on an incumbent's revenue needs in other contexts, not on the proper level of compensation for the competitive use of discrete facilities. The use of such existing data to develop reliable historical cost figures for particular categories of facilities would, therefore, have been exceedingly difficult. See pp. 48-49, *infra*.

Third, Verizon argues that, because the 1996 Act ties the wholesale rates that new entrants may be charged for telecommunications services sold for resale under Sections 251(c)(4) and 252(d)(3) to incumbents' retail rates (which allegedly were set on the basis of historical costs), principles of symmetry in statutory construction dictate that historical costs be the basis for network element rates as well. Verizon Pet. Br. 22-23. But nothing in the text of Sections

251(c)(4) and 252(d)(3) — which provide that new entrants may purchase such services "at wholesale rates," which are to be based on "retail rates charged to subscribers"—inexorably ties those rates to historical costs.[14] Any such connection depends upon the particular ratemaking method that state regulators employed to develop the pertinent retail rates.

Moreover, even if the rates for services sold for resale would in many instances be derived in some respect from historical costs, that does not mean that Congress intended that network element rates also would be tied to historical costs. The network element and resale entry vehicles are separate options for new entrants and serve distinct purposes. The pricing standards for those entry vehicles are contained in separate statutory subsections and are described in distinct terms. Section 252(d)(1) provides that rates for network elements should be based upon "cost" and thus should be developed from the ground up. Construing "cost" to mean forward-looking cost serves the competitive purposes of the 1996 Act by ensuring that new entrants make efficient choices about whether to lease network elements or build facilities of their own. *Local Competition Order* (para. 620), J.A. 327-328.

Section 252(d)(3), on the other hand, provides that wholesale rates for resale services should be developed from the top down—starting with existing retail rates and excluding the portion of such rates attributable to categories of "costs that will be avoided by the local exchange carrier."

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[14] Section 252(d)(3) provides that:

> For the purposes of section 251(c)(4) of this title, a State commission shall determine wholesale rates on the basis of retail rates charged to subscribers for the telecommunications service requested, excluding the portion thereof attributable to any marketing, billing, collection, and other costs that will be avoided by the local exchange carrier.

47 U.S.C. 252(d)(3).

That standard recognizes that incumbents' retail rate structures traditionally have been laden with implicit subsidies and thus are not necessarily cost-based (with reference to either historical or forward-looking costs). The wholesale rate standard ensures that companies choosing to enter the market through resale have a margin within which to compete, regardless of whether an incumbent's retail service rates are cost-based, above-cost, or below-cost.[15] Given the different purposes underlying the pricing standards for network elements and resale services, as well as the different statutory language describing those standards, there is no reason to conclude that Congress intended that the pricing standards be symmetrical in their reliance on historical costs. In other words, even if Congress understood that wholesale rates for retail services ordinarily (but not invariably) would have historical cost-based retail rates as a starting point, it would not follow that Congress intended that rates for network elements be based on historical, not forward-looking, costs.

B. The Principle Of Constitutional Avoidance Does Not Require That "Cost" Be Construed As Historical Cost

Verizon next invokes the principle of constitutional avoidance to advance its construction of the term "cost" in Section 252(d)(1). Verizon contends that, in order to avoid Takings Clause concerns, Section 252(d)(1) must be construed to

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[15] Congress's purpose of ensuring a margin for competitive entry through resale even for non-cost-based rates is evident in Section 251(c)(4)(B), which permits state commissions to "prohibit a reseller that obtains at wholesale rates a telecommunications service that is available at retail only to a category of subscribers from offering such service to a different category of subscribers." Presumably, Congress intended that the provision could apply, for instance, to services provided at below-cost retail rates (*e.g.*, for rural customers), so that new entrants could compete with incumbents with respect to subsidized services, but could not extend the subsidy to new classes of customers that were not beneficiaries of the subsidy under state ratemaking policy.

allow incumbent LECs to lease network elements at rates based on whatever amount the incumbents may have paid for those elements in the past. Verizon Pet. Br. 24-31.

This Court and others have rejected efforts to invoke the avoidance principle in the Takings Clause context to "frustrate[] permissible applications of a statute or regulation" absent a concrete showing that government action will necessarily produce a taking without just compensation. *United States* v. *Riverside Bayview Homes, Inc.*, 474 U.S. 121, 128 (1985); *National Mining Ass'n* v. *Babbitt*, 172 F.3d 906, 917 (D.C. Cir. 1999); cf. *Federal Power Comm'n* v. *Hope Natural Gas*, 320 U.S. 591, 602 (1944) (one who challenges the constitutionality of a ratemaking order "carries the heavy burden of making a convincing showing that it is invalid because it is unjust and unreasonable in its consequences").[16] Verizon has not even attempted to make such a showing here.

As an initial matter, any suggestion that the FCC's adoption of TELRIC will deny the incumbent LECS constitutionally adequate compensation has a speculative quality, since the actual rates that incumbents may charge for network elements are ultimately set by state public utility commissions, not by the FCC itself. The FCC has simply

[16] Verizon contends that *Riverside Bayview* has no application where the constitutional concern is not whether a taking has occurred, but rather whether the compensation for the taking is just. Verizon Pet. Br. 43. But *Riverside Bayview* is appropriately viewed as a specific application of the principle that the constitutional avoidance doctrine is properly invoked to prevent "serious constitutional problems," not merely speculative ones. Nor is *United States* v. *Security Industrial Bank*, 459 U.S. 70 (1982), to the contrary. The Court has explained that *Security Industrial Bank* involved a "substantial" claim that a particular construction of a statute "would in every case constitute a taking." *Riverside Bayview*, 474 U.S. at 128 n.5. Verizon does not attempt to demonstrate that the application of TELRIC would produce unconstitutional results in all, or even a substantial number of, applications.

established the methodology that the state commissions are to apply in individual circumstances. The FCC also has not prescribed specific depreciation rates or rates of return—both of which are necessary components of any network element rates established under TELRIC. Instead, the FCC has left it to state commissions to establish rates of return and depreciation rates. See *Local Competition Order* (para. 702), J.A. 395-396; see also U.S. Pet. App. 17a (court of appeals observes that, "[u]ntil the actual rates are established" by state commissions for network elements, "we cannot conclude whether the impact of TELRIC driven rates will constitute a taking"). In addition, the FCC has expressly stated that incumbents may "seek relief from [its] pricing methodology if they provide specific information to show that the pricing methodology, as applied to them, will result in confiscatory rates." *Local Competition Order* (para. 739), J.A. 422. The FCC's acknowledgment of the potential for relief where confiscation can be demonstrated—rather than merely asserted—undermines any suggestion that the Order at issue will produce confiscatory results in *any* circumstance. Even aside from the foregoing considerations, Verizon has failed to demonstrate that TELRIC raises serious constitutional concerns.

As regulated public utilities, incumbent LECs are subject to the regulatory takings analysis of *Duquesne Light Co.*, *supra*, and *Hope Natural Gas*, *supra*. In *Duquesne*, as in a consistent line of earlier decisions, this Court rejected the argument that the Takings Clause protects utilities from regulatory measures that deny them recovery of all prudently incurred historical costs. See 488 U.S. at 301-302, 307-316; accord *FERC* v. *Pennzoil Producing Co.*, 439 U.S. 508, 517-520 (1979); *Market St. Ry.* v. *Railroad Comm'n*, 324 U.S. 548, 553-554, 564-568 (1945). The Court explained that the Constitution protects a public utility only from "the net effect of the rate order on its property," *Duquesne*, 488 U.S. at 314, so that "[i]f the total effect of the rate order cannot be said to be unreasonable, judicial inquiry . . . is at an end," *id*. at 310 (quoting *Hope*, 320 U.S. at 602).

Here, as in *Duquesne*, whether or not the challenged methodology denies regulated companies full recovery of certain prudently incurred historical costs is itself of no constitutional significance. Indeed, unlike in *Duquesne*, the incumbents here are allowed to recover the full forward-looking costs of the facilities at issue—a measure closely analogous to fair market value, which is the standard for determining whether the government has paid just compensation for private property taken for public use. See pp. 35-36, *infra*. And here, as in *Duquesne*, "[n]o argument has been made" that the regulatory measure at issue "jeopardize[s] the financial integrity of the companies, either by leaving them insufficient operating capital or by impeding their ability to raise future capital." 488 U.S. at 312. To the contrary, Verizon and most other incumbents have enjoyed extremely healthy returns in recent years, *after* they were required to lease network elements at rates based on forward-looking costs.[17]

1. Verizon nonetheless contends that the FCC's adoption of TELRIC is inconsistent with *Duquesne* on the theory that

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[17] The interstate rates of return on the major incumbents' regulated activities in 1999, as measured under a historical cost approach, showed a weighted arithmetic mean of 18.50%, including returns of 22.89% for GTE, 20.99% for BellSouth, 18.80% for SBC Communications, 19.06% for U S WEST, and 13.66% for Bell Atlantic. See Interstate Rate of Return Summary (FCC Apr. 10, 2001) (http://www.fcc.gov/Bureaus/Common_Carrier/Reports/FCC-State_Link/IAD/ror00.pdf). Preliminary reports on interstate regulated earnings in 2000 show even higher average returns of 19.53%. See Interstate Rate of Return Summary, Years 1991 through 2000 (FCC May 3, 2001) (http://www.fcc.gov/Bureaus/Common_Carrier/Reports/FCC-State_Link/IAD/ror00.pdf); see also Seth Schiesel, *No End to Upheaval in Telecom Industry*, N.Y. Times, Dec. 18, 2000, at C30 ("The local phone giants that formerly had Bell in their names, led by Verizon Communications and SBC Communications, are ascendant these days, even as the long-distance industry essentially collapses around them.").

the FCC has improperly "switche[d]" compensation methodologies. Verizon Pet. Br. 26-31.[18] That argument turns *Duquesne* on its head. In *Duquesne*, the Court upheld a state law that "suddenly and selectively," 488 U.S. at 313, foreclosed recovery of a $35 million investment that was prudent when made, even though the methodology in effect at the time of the investment would have permitted such recovery. Thus, *Duquesne* affirms the discretion of regulators to alter rate-setting methodologies to accommodate changes in regulatory policy, even if, as in *Duquesne* itself, the new methodology results in "stranded" investment.

Verizon counters that a change in methodologies is permissible under *Duquesne* only if the new methodology produces a constitutionally adequate rate of return as measured under the old methodology. Verizon Pet. Br. 27-28. That argument is both inaccurate and irrelevant.

In the first place, *Duquesne* holds no such thing. The passage on which Verizon relies states a sufficient, but not necessary, basis for rejecting the utility's constitutional claim in that case. See *Duquesne*, 488 U.S. at 312. And, even if *Duquesne* did stand for the rule that Verizon ascribes to it, such a rule would not advance Verizon's position here. Under any plausible reading of *Duquesne*, the relevant question is the "overall impact," *ibid.*, of a methodological decision on a utility's regulated returns, not the amount of

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[18] It is well settled that, within reasonable bounds, companies operating in regulated industries have no vested interest in any particular regulatory regime. See, *e.g.*, *General Tel. Co. of the S.W.* v. *United States*, 449 F.2d 846, 864 (5th Cir. 1971) ("The property of regulated industries is held subject to such limitations as may reasonably be imposed upon it in the public interest and the courts have frequently recognized that new rules may abolish or modify pre-existing interests."); cf. *Lucas* v. *South Carolina Coastal Council*, 505 U.S. 1003, 1027 (1992) ("the property owner necessarily expects the uses of his property to be restricted, from time to time, by various measures newly enacted by the State in legitimate exercise of its police powers").

cost recovery allowed for individual facilities, such as a nuclear power plant in *Duquesne* or a telephone loop here. Verizon has made no effort to show that the "overall impact" of the FCC's adoption of a forward-looking methodology to determine the rates at which network elements are leased leaves incumbents with a constitutionally inadequate return, even as measured under a historical cost methodology. See note 17, *supra*.

Moreover, Verizon's argument rests on the erroneous premise that, until 1996, the FCC had committed itself to a historical cost methodology and that its adoption of TELRIC marked an abrupt departure from that commitment. See Verizon Pet. Br. 29. It is true that state and federal regulators for many years used historical costs as the basis for setting retail rates paid by consumers and charges for particular services (such as use of the local network to originate or terminate long-distance calls). The Order under review here does not regulate those rates and charges.[19] It instead regulates the charges paid by new entrants for the use of network elements—an activity that had little precedent from which the FCC can be accused of departing. And, even in those other contexts, the FCC and many state commissions abandoned a pure historical cost approach years ago because of its methodological shortcomings. See, *e.g.*, *National Rural Telecom Ass'n* v. *FCC*, 988 F.2d 174, 178 (D.C. Cir. 1993) (discussing price cap regime). Thus, in adopting a forward-looking methodology in the present context, the FCC not only was addressing a new regulatory subject matter, but also was continuing a trend away from traditional forms of regulation based on historical costs.

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[19] See generally *Access Charge Reform, Sixth Report and Order*, FCC No. 00-193 (May 31, 2000), petitions for review pending *sub nom. Texas Office of Pub. Util. Counsel* v. *FCC*, No. 00-60434 (5th Cir. filed June 26, 2000) (and consolidated cases).

Even if there were some plausible basis (which there is not) for contending that the government has impermissibly "switched" the rules on incumbent LECs, the appropriate focus of inquiry would be the impact of the 1996 Act and implementing regulations as a whole, not just of the individual regulatory decisions that the incumbents oppose. See *Colorado Springs Prod. Credit Ass'n* v. *Farm Credit Admin.*, 967 F.2d 648, 653 (D.C. Cir. 1992) (it is appropriate to consider the benefits and burdens of the "overall legislative 'transaction'" in assessing a takings claim). The 1996 Act confers significant benefits on Verizon and the other major incumbents by, for example, eliminating or reducing restrictions on their entry into the long-distance market in return for their compliance with Sections 251 and 252. See 47 U.S.C. 271 (prescribing method whereby Bell companies such as Verizon may obtain permission to enter long-distance market); 1996 Act, Title VI, § 601(a)(2), 110 Stat. 143 (relieving GTE from restrictions on provision of long-distance service); see generally *BellSouth Corp.* v. *FCC*, 162 F.3d 678, 690 (D.C. Cir. 1998) (describing benefits provided to incumbent LECs by the 1996 Act).[20] It is, moreover, implausible to assert, as Verizon now does, that the regulatory steps necessary to open monopoly markets to full competition have either taken them by surprise or left them with anything short of a robust return on their investments.[21]

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[20] Pursuant to Section 271, the FCC has authorized Verizon entities to offer long distance services in New York and Massachusetts—activities that such entities were precluded from engaging in before the adoption of the 1996 Act. See *AT&T* v. *FCC*, 220 F.3d 607 (D.C. Cir. 2000); *Application of Verizon New England, Inc., et al. For Authorization To Provide In-Region, Inter-LATA Servs. in Massachusetts* (CC Docket No. 01-9), FCC 01-130 (Apr. 16, 2001), appeal pending *sub nom. WorldCom, Inc.* v. *FCC*, No. 01-1198 (D.C. Cir. filed Apr. 25, 2001).

[21] See Herbert Hovenkamp, *The Takings Clause and Improvident Regulatory Bargains*, 108 Yale L.J. 801 (1999) (repudiating incumbents' claim of a breached "regulatory contract"); Jim Chen, *The Second Coming*

2. Relying on *Brooks-Scanlon Co.* v. *Railroad Commission*, 251 U.S. 396 (1920), Verizon contends that, in determining the "total effect" of a methodological decision for purposes of the *Duquesne* analysis, a regulator must disregard profits from lines of business outside that regulator's own jurisdiction. See Verizon Pet. Br. 33-34. Indeed, Verizon asserts, the FCC was required under *Brooks-Scanlon* "to set UNE [*i.e.*, network element] rates that would allow the UNE business to generate a sufficient return to stand on its own." *Id.* at 35. *Brooks-Scanlon* has no application to the circumstances here. In any event, whether or not it is appropriate under this Court's authorities to assess the incumbents' returns from the leasing of network elements in isolation, there is no reason to conclude that those returns are constitutionally inadequate under the FCC's methodology. That is because the inquiry required under the FCC's methodology—*i.e.*, the cost of obtaining the useful features of a network element in today's market—is closely analogous to an inquiry into fair market value. And fair market value is the touchstone for determining whether just compensation has been paid for private property taken for public use.

a. In *Brooks-Scanlon*, the Court held that a State could not force a company engaged in an *unregulated* "sawmill and lumber business" to operate an unprofitable railroad on the theory that the losses from the railroad would be offset by the profits from the sawmill and lumber business. 251 U.S. at 399.[22] No similar arrangement is at issue here. The "total

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of Smyth v. Ames, 77 Tex. L. Rev. 1535, 1566 (1999) ("The LECs' exhaustive knowledge of the laws, policy, and jurisprudence of regulated industries, compounded by their active lobbying before the passage of the Telecommunications Act, estops them from plausibly complaining of surprise, much less an unconstitutional violation of public faith.") (internal quotation marks omitted).

[22] The Court acknowledged, however, that if a company wished to continue operating a railroad pursuant to a state charter, the company could

effects" inquiry mandated by *Duquesne* should, at a minimum, permit consideration of a regulated firm's overall rate of return from all of its interrelated *regulated* activities. As to those activities, the appropriate question is whether a particular government policy requires the firm to "operate its *entire* business at a loss," for the firm is entitled only to "just compensation for [its] over-all services to the public." *Baltimore & Ohio R.R.* v. *United States*, 345 U.S. 146, 148-150 (1953) (emphasis added); see *Broad River Power Co.* v. *South Carolina*, 281 U.S. 537, 544 (1930) (*Brooks-Scanlon* simply prevents regulators from considering revenues from an unregulated business in assessing whether a regulated business may be abandoned as unprofitable).[23]

Verizon does not contend that the incumbent LECs are being required to operate their "entire [regulated] business" at a loss. Nor does Verizon contend that the incumbents are being compelled to operate those activities within the federal regulatory jurisdiction at an overall rate of return that is unconstitutionally low.[24] And for good reason. The available data demonstrate that the incumbents' interstate earnings

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be required "to fulfil an obligation imposed by the charter even though fulfilment in that particular may cause a loss." 251 U.S. at 399.

[23] Although one passage in *Brooks-Scanlon* states that "[a] carrier cannot be compelled to carry on even a branch of business at a loss," 251 U.S. at 399, Judge Friendly correctly observed, even before *Duquesne*, that any such proposition is inconsistent with modern regulatory takings precedent and "is not the law." *In re Valuation Proceedings Under Sections 303(c) and 306 of the Reg'l Rail Reorganization Act*, 439 F. Supp. 1351, 1357 n.12 (Spec. Ct. 1977) (citing cases).

[24] Contrary to Verizon's suggestion (see Verizon Pet. Br. 34), the FCC considered only the incumbents' revenues from the federal jurisdiction in assessing the net effect of its decision to adopt TELRIC. See *Local Competition Order* (para. 737 & n.1756), J.A. 421 (citing *Smith* v. *Illinois Bell Tel. Co.*, 282 U.S. 133 (1930)). The FCC concluded that no incumbent had presented persuasive evidence that the application of TELRIC would have a significant impact on the financial integrity of its federally regulated activities. *Local Competition Order* (para. 738), J.A. 421-422.

have been robust and, if anything, have grown since the 1996 Act was enacted and implemented. See note 17, *supra*.[25]

b. Verizon's contention that the FCC's forward-looking cost methodology presents serious Takings Clause concerns fares no better if, as Verizon urges, the incumbents' compensation for leasing network elements is considered in isolation from their compensation for other regulated activities.

Under traditional just compensation principles, when the government commits private property to public use, it does not compensate the owner for its historical costs—*i.e.*, whatever amount the owner paid for the property in the past. Instead, the government pays the owner the fair market value of the property—*i.e.*, "what a willing buyer would pay in cash to a willing seller" in the current market. *United States* v. *Miller*, 317 U.S. 369, 374 (1943); accord *United States* v. *564.54 Acres of Land*, 441 U.S. 506, 513-514 (1979).

Fair market value is closely analogous to forward-looking cost. Where there is a fully competitive market for an item, its forward-looking cost (which includes a normal profit) approximates the going market price; where there is not (yet) a fully competitive market, ascertainment of an item's forward-looking cost requires a more direct inquiry into the current costs of replacing its useful functions. Either way

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[25] Notwithstanding *Smith* v. *Illinois Bell Telephone Co.*, *supra*, it is arguable that, in the present context, no taking without just compensation could be found unless the incumbents demonstrate an inadequate return on the totality of their interrelated regulated activities, whether those activities are principally regulated by the federal government or by the States. The incumbents' facilities that are at issue here (*i.e.*, network elements) are used to provide services within the jurisdiction of each sovereign. And the incumbents' obligation to provide interconnection and network elements to new entrants at "just and reasonable" rates is neither strictly interstate service nor strictly intrastate service as those terms have traditionally been used. See *Iowa Utils. Bd. I*, 525 U.S. at 380 (recognizing that the local competition provisions of the 1996 Act "clearly 'apply' to intrastate service, and clearly confer 'Commission jurisdiction' over some matters").

the inquiry is conducted, the forward-looking cost of any item, like its fair market value, is affected by developments in technology, production, and other factors since the item was placed into service. In many cases, the forward-looking cost of an asset may exceed its fair market value, because the asset can be replaced in today's market only by one that has more sophisticated capabilities and therefore commands a higher price.

What Verizon seeks here, in contrast, is a compensation rule entitling incumbent LECs to recover the historical costs of their assets, even (or, perhaps, especially) when those costs far exceed the forward-looking cost and the fair market value of those assets. Nothing in this Court's Takings Clause jurisprudence compels such a result.

3. Verizon also invokes the notion of "stranded investment" to justify setting network element rates based on historical costs. Verizon claims that unspecified state or federal regulators, at some unspecified point in the past, compelled incumbent LECs to build facilities and then artificially slowed the incumbents' recovery of the costs of those facilities by extending the depreciation schedules beyond the facilities' economic lives (thereby maintaining low retail rates). Adoption of a ratemaking methodology based on forward-looking costs now, Verizon contends, would unconstitutionally deny incumbents the benefit of a putative regulatory bargain, under which they were supposedly guaranteed the eventual recovery of the full historical costs of those facilities. See Verizon Pet. Br. 4, 29-30. That claim fails for reasons already discussed and for additional reasons as well.

First, in *Duquesne*, this Court specifically held that a regulatory action that produces "stranded" investment—*i.e.*, investment for which a firm cannot recover its historical costs—does not violate the Takings Clauses unless the firm is left with an unconstitutionally low rate of return on the totality of its regulated activities. See pp. 28-29, *supra*. Verizon makes no such claim here. Instead, relying on cost models developed for distinct universal service purposes[26] and on other off-point sources,[27] Verizon asserts that the application of TELRIC to determine network element rates would disallow roughly half of the existing regulated rate base. Verizon Pet. Br. 10-11. In the Order under review, the FCC reasonably rejected similar claims, because they were unsubstantiated and "unrealistically assume[d] that competitive entry would be instantaneous," whereas competition is, in fact, developing only gradually. *Local Competition Order* (paras. 688, 707), J.A. 385-386, 400-401. See *Southwestern Bell Tel. Co.* v. *FCC*, 153 F.3d 523, 541 (8th Cir. 1998) (noting the "relatively insignificant headway UNE purchasers have made in the telecommunications market"). In order for network element prices to cause stranded investment (even as a theoretical matter), an incumbent would have to lose a substantial share of its customers to a new entrant, and to do so before the investment has been recovered through existing mechanisms. As long as the incumbent retains a significant

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[26] The FCC has explained that the universal service cost model "may not be appropriate * * * [for] determining prices for unbundled network elements." *In re Federal-State Joint Bd. on Universal Serv., Ninth Report and Order and Eighteenth Order on Reconsideration*, 14 F.C.C.R. 20,432 (para. 41 & n.125) (1999).

[27] Verizon cites various sources purporting to show that the costs of network elements are significantly lower under a forward-looking methodology than under a historical cost methodology. See Verizon Pet. Br. 10 nn.4 & 5. But those sources are inapposite. They make a comparison not between forward-looking costs and historical costs, but rather between forward-looking costs and retail revenues. Historical costs and retail revenues are not commensurable; retail revenues can be higher or lower than costs for reasons (*e.g.*, implicit subsidies and retail-specific costs) that have nothing to do with methodological differences in assigning costs to the underlying facilities. Even apart from that conceptual flaw, the figures cited by Verizon reflect only the incumbents' self-serving allegations in local competition litigation in 1996, soon after the *Local Competition Order* was issued and before the States had come close to completing forward-looking cost studies.

market share (as all of them still do), the incumbent continues to recover the costs of its investments through, among other things, access charges and local retail rates, which are not set under the TELRIC methodology.[28]

Second, Verizon has not attempted to demonstrate that incumbent LECs' facilities are, in fact, "underdepreciated" today. See *Local Competition Order* (paras. 738-739), J.A. 421-422. There is ample reason to conclude that they could not make such a showing. In light of curative measures adopted over the past 12 years, the FCC recently determined that incumbents' facilities are, as a general matter, no longer underdepreciated and, indeed, that "their depreciation reserves are at a historic high level of 51 percent of total plant" and increasing by "over $10 billion per year." *In re 1998 Biennial Regulatory Review—Review of Depreciation Requirements for Incumbent LECs*, 15 F.C.C.R. 242 (para. 65) (1999); accord *In re Federal-State Joint Bd. on Universal Serv., Tenth Report and Order*, 14 F.C.C.R. 20,156 (para. 427) (1999); David Gabel & David I. Rosenbaum, *Who's Taking Whom: Some Comments And Evidence on the Constitutionality of TELRIC*, 52 Fed. Comm. L.J. 239, 265-267 (2000) (incumbents' claims of stranded investment are "spurious" because "the book value

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[28] The FCC has acted to protect incumbents' access revenues from rapid erosion in the new regulatory regime. See *Competitive Telecomms. Ass'n* v. *FCC*, 117 F.3d 1068, 1073-1075 (8th Cir. 1997) (upholding transitional rules that allow the assessment of certain access charges against new entrants that lease network elements); *Implementation of the Local Competition Provisions of the Telecommunications Act of 1996* (CC Docket No. 96-98), FCC 00-183 (June 2, 2000) (adopting rules that, pending further study, preserve incumbents' access revenues by denying new entrants access to loop and transport network element combinations unless they provide a significant amount of local exchange service in addition to any access services they might offer), petition for review pending *sub nom. Competitive Telecomms. Ass'n* v. *FCC*, No. 00-1272 (D.C. Cir. filed June 23, 2000).

of the [incumbents'] assets is significantly less than the market value of the assets").[29] Verizon does not mention that determination, much less attempt to refute it.[30]

Third, even the most basic factual premise of Verizon's "stranded investment" argument—that state regulators compelled, rather than simply approved, the investments at issue—is subject to considerable doubt. As Professor Hovenkamp has explained, "such situations must be regarded as the exception rather than the rule," because, "[i]n most cases, the instigator of expansion is the regulated firm itself." Herbert Hovenkamp, *The Takings Clause and Improvident Regulatory Bargains*, 108 Yale L.J. 801, 822 (1999). More generally, Verizon's claims of a breached "regulatory contract" are largely fictitious. "In most circumstances," as Professor Hovenkamp has observed, "the utility investor's investment-backed expectations are not all that different from the expectations of the investor in an ordinary enterprise, who can almost never expect compensation for obsolescence and only rarely for changes in government policy." *Id.* at 834. Thus, "[g]iven that society has been debating the large costs and relatively small benefits of regulation for more than twenty-five years, one can hardly argue that perpetual freedom from competition must be a

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[29] Verizon errs in broadly asserting that the forward-looking cost of an incumbent's assets necessarily would be "substantially below book value." Verizon Pet. Br. 29. If assets have been in service for some time and have been fully depreciated (although they still have a substantial useful life remaining), the assets would no longer have any book value. A forward-looking cost methodology would not take into account past cost recovery, but instead would seek to provide an opportunity for full recovery of the cost of replacing the assets' useful functions.

[30] In addition, the effect of any "underdepreciation" would most likely be offset by the incumbents' ample returns on investment, which have far exceeded the incumbents' cost of capital in recent years. See note 17, *supra* (describing incumbents' rates of return for 1999 and 2000). It is meaningless to examine depreciation in isolation from other variables in the compensation calculus, such as the cost of capital.

part of the investment-backed expectations of the utility shareholder." *Ibid.*

Finally, the FCC has not foreclosed the possibility of providing a remedy for stranded investment, if the need for such a remedy is demonstrated. The FCC has explained, however, that such a remedy would sensibly be implemented not through the rates that new entrants pay for network elements, but rather through a competitively neutral federal or state funding mechanism. See *Local Competition Order* (para. 739), J.A. 422. There is no logical reason to distort the prices of all network elements, and thereby warp the course of competition nationwide, simply to accommodate the incumbents' unsubstantiated claims that some facilities in some States may remain underdepreciated despite recent reforms.[31]

In sum, the doctrine of constitutional avoidance invoked by Verizon is properly applied only "to avoid *serious* constitutional doubts, not to eliminate all possible contentions that the statute *might* be unconstitutional." *Reno* v. *Flores*, 507 U.S. 292, 314 n.9 (1993) (internal citation omitted); cf. *Public Citizen* v. *United States Dep't of Justice*, 491 U.S. 440, 481 (1989) (Kennedy, J., concurring in judgment) (constitutional avoidance doctrine "should not be given too broad a scope lest a whole new range of Government action be proscribed by interpretive shadows cast by constitutional provisions

[31] Verizon suggests, in passing, that the FCC's implementation of Section 254 casts doubt on its implementation of Sections 251 and 252. See Verizon Pet. Br. 12-14. Verizon has forfeited any challenge to the FCC's implementation of Section 254. In *GTE Serv. Corp.* v. *FCC*, No. 99-1244, one of Verizon's corporate predecessors challenged the adequacy of federal universal service funding under Section 254. Shortly after we filed our brief on the merits, Verizon successfully moved to dismiss the case. See 121 S. Ct. 423 (2000). The underlying decision of the Fifth Circuit, rejecting all relevant challenges to the pace and nature of the FCC's implementation of Section 254, is thus now final and controlling. See *Texas Office of Public Util. Counsel* v. *FCC*, 183 F.3d 393 (5th Cir. 1999).

that might or might not invalidate it"). At most, Verizon has raised the possibility that TELRIC, after its implementation by state commissions in individual circumstances, might produce constitutionally inadequate compensation. Such speculation does not warrant application of the constitutional avoidance doctrine to defeat the FCC's reasonable construction of the 1996 Act.

II. THE FCC REASONABLY DETERMINED THAT A FORWARD-LOOKING COST METHODOLOGY MOST EFFECTIVELY IMPLEMENTS THE COMPETITIVE OBJECTIVES OF THE 1996 ACT AND IS ADMINISTRATIVELY WORKABLE

Verizon contends that the FCC's decision to adopt a forward-looking, rather than historical, cost methodology to determine rates at which incumbent LECs lease network elements fails in various respects to satisfy the reasoned decisionmaking standards of the Administrative Procedure Act, 5 U.S.C. 701 *et seq.* See Verizon Pet. Br. 44-49. Those challenges, too, are without merit.

1. A central premise underlying the 1996 Act is that it would make little economic sense to expect new entrants, particularly in the short term, to construct all of the telecommunications facilities that they might need in order to serve their customers. In some (but by no means all) circumstances, the economic and social costs of duplicating an incumbent's facilities would exceed the corresponding benefits: Significant resources would be expended, and needless disruptions would occur (*e.g.*, streets would be dug up, customers would be inconvenienced), without commensurate increase in the value or diversity of telecommunications services. For that reason, and to jump-start competition in local telecommunications markets, Congress directed the FCC to identify those elements that new entrants should be entitled to lease from incumbents at "cost." 47 U.S.C. 251(c)(3) and (d)(2), 252(d)(1).

The FCC determined that basing the rates for access to those elements on incumbents' historical costs, when those costs exceed forward-looking costs, would either keep new entrants out of the market altogether or impair their competitive position by inducing them to construct inefficient, duplicative facilities. See *Local Competition Order* (paras. 620, 672, 679, 705), J.A. 327-328, 375-376, 379-380, 398-399.[32] The FCC reasoned that either result would conflict with Congress's goals of bringing meaningful competition to local telecommunications markets on an accelerated basis, promoting the efficient use of existing network facilities (many of which embody enormous economies of scale and density), and encouraging potential competitors to make economically rational choices about whether, or how, to enter local markets. See *Local Competition Order* (paras. 679, 704-707), J.A. 379-380, 397-401.

That determination is entirely reasonable. A principal objective of setting compensation levels in regulated industries has always been to "restore * * * the price that would result through the mechanism of a truly competitive market." *Farmers Union Cent. Exch., Inc.* v. *FERC*, 734 F.2d 1486, 1510 (D.C. Cir.), cert. denied, 469 U.S. 1034 (1984). And, as courts and commentators have recognized, historical costs are "essentially irrelevant" to entry decisions in competitive markets, "since those costs are 'sunk' and unavoidable and are unaffected by the new production decision." *MCI Communications*, 708 F.2d at 1117. In attempting to saddle new entrants with an incumbent's own historical costs, Verizon asks this Court to ignore "[o]ne of the most important lessons of economics"—that "you should look at the marginal costs and marginal benefits of decisions

[32] Similarly, setting network element rates on the basis of historical costs, if those costs were *lower* than forward-looking costs, would encourage inefficient use of incumbents' facilities and deter the efficient construction of new competitive facilities.

and ignore past or sunk costs." Paul A. Samuelson & William D. Nordhaus, *Economics* 167 (16th ed. 1998).

Nor does the FCC's adoption of a forward-looking approach to costs in this proceeding constitute an arbitrary departure from the FCC's use of a historical approach to costs in other proceedings. See Verizon Pet. Br. 44-45, 47-48. The FCC did not simply change, without explanation, regulatory approaches that it had previously employed. Rather, as discussed above, the FCC explained that setting network elements rates based on forward-looking costs is the appropriate approach in the *new* competitive environment contemplated by the 1996 Act. The FCC's earlier decisions employing historical costs typically occurred in a monopoly environment in which opening markets to competition was not a primary goal.

Verizon thus errs in asserting that the FCC's rejection of a historical-cost methodology, on ground of economic inefficiency, is arbitrary given the FCC's earlier justification for price cap regulation as encouraging efficient operations. Verizon Pet. Br. 47-48. Although the FCC adopted price caps in part to provide incentives for incumbent LECs to act efficiently, the FCC did so in the pre-1996 Act regulatory environment. In that context, the FCC was concerned with balancing the interests of incumbents and their (largely captive) customers, not, as in the current context, with encouraging efficient competitive entry. It does not follow that efficiency levels that were appropriate for the former task are also appropriate for the latter task.[33] Similarly, when the

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[33] Verizon also misconstrues the FCC's 1997 adjustment of the price cap productivity factor as reflecting a determination that incumbents were operating efficiently. But that adjustment was designed to measure the annual rate at which the incumbents' efficiency improvement exceeded that of the general economy. The FCC made no judgment about the reasonableness of the incumbents' underlying rates based on historical costs. See generally *In re Access Charge Reform, First Report and Order*, 12 F.C.C.R. 15,982 (paras. 289-290, 295) (1997), aff'd, *Southwestern Bell*

FCC chose a historical cost methodology for setting rates in the cable television context, the FCC was concerned with preventing a monopolist from charging excessive rates to its retail customers, not with setting the rates that an incumbent could charge competitors for use of its facilities during a transition to competition. See *Time Warner Entm't Co.* v. *FCC*, 56 F.3d 151, 179, 184-185 (D.C. Cir. 1995), cert. denied, 516 U.S. 1112 (1996); 47 U.S.C. 543(b) (1994).

2. Verizon further suggests that the use of forward-looking costs to set network element rates will discourage facilities-based competition, producing instead a proliferation of competitors providing service solely through use of the incumbent's facilities. Verizon Pet. Br. 48-49. That argument is without merit. To begin with, Verizon's professed policy concerns about the nature of the competition that incumbents may encounter are analytically unhinged from Verizon's legal challenge to the FCC's methodology for determining network element rates. Congress, not the FCC, made the basic decision to accelerate competition by giving new entrants the right to enter local markets by leasing certain elements in the incumbent's network rather than duplicating all such elements on their own. See 47 U.S.C. 251(c)(3) and (d)(2).[34] Even if (as Verizon suggests) there were some policy justification for giving new entrants additional incentives to invest immediately in more facilities of

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Tel. Co. v. *FCC*, 153 F.3d 523 (8th Cir. 1998). On review, the D.C. Circuit did not find that the productivity adjustment was too demanding of incumbents, as Verizon suggests. Verizon Pet. Br. 47-48. The court found only that the productivity adjustment was inadequately supported in the record. See *USTA* v. *FCC*, 188 F.3d 521, 524-526 (D.C. Cir. 1999).

[34] Congress also authorized entry by resale of services purchased by new entrants from incumbents at wholesale prices. 47 U.S.C. 251(c)(4). The 1996 Act does not favor entry by one means over another. It does contemplate, however, that new entrants ultimately will develop at least some facilities of their own. See *Local Competition Order* (para. 12), J.A. 271-272.

their own, it would make little sense to accomplish that objective by forcing new entrants, in the circumstances in which they are entitled to lease elements, to pay rates based on whatever amounts happen to appear on an incumbent's accounting books. Those amounts would vary widely and arbitrarily from incumbent to incumbent, and could be higher or lower than the forward-looking costs of the elements at issue. The FCC's decision to reject that approach is reasonable.

Verizon's policy concerns are refuted, moreover, by industry developments under the new regulatory regime. Since 1996, network element rates have reflected forward-looking costs. See p. 21 note 12, *supra*. And, both before and after this Court's decision in *Iowa Utilities Board I*, new entrants have been able in many (but not all) contexts to lease the elements necessary to provide service to their customers, as some of them must in order to develop a customer base sufficient to support further capital investments. See *Iowa Utils. Bd. I*, 525 U.S. at 387-392. Yet, in many settings, extensive competition of any kind has yet to develop; incumbents still control approximately 93% of total local telecommunications lines, and much of the existing competition in local markets, particularly in business markets, is provided by carriers that have built or purchased facilities of their own, rather than leasing the facilities from incumbents.[35] Moreover, new entrants have strong inherent incentives to build their own facilities, so as to avoid having to deal with, and rely on, their chief competitors, the incumbents, in order to do business. See *Iowa Utils. Bd.* v. *FCC*, 120 F.3d 753, 817 (1997), aff'd in part and rev'd in part, *Iowa Utils Bd. I*, *supra*. Dennis W. Carlton & Jeffrey M. Perloff, *Modern Industrial Organization* 501 (2d ed. 1994); see also U.S. Pet.

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[35] See *Local Telephone Competition: Status as of June 30, 2000* (Industry Analysis Division, FCC, 2000) (available at http://www.fcc.gov/ccb/stats [file name: LCOM1200.PDF]).

Br. 42-44 (describing practical difficulties encountered by new entrants in leasing network elements).

3. Verizon further argues that any forward-looking approach, which asks what it would cost to replace the functions of network facilities in today's market, is so "administratively unworkable" that the FCC lacks discretion to adopt it. Verizon Pet. Br. 44-48. That claim is unsound.

For decades, commentators have debated the relative merits of the historical cost approach (also known as the "prudent investment" rule) and a forward-looking alternative that focuses on replacement costs (also known as the "fair value" rule). That debate has not been resolved, and each approach has its champions.[36] In *Smyth* v. *Ames*, 169 U.S. 466 (1898), this Court held that the use of a "fair value" methodology in the ratemaking context was constitutionally compelled; although the Court later rescinded that requirement in *Hope Natural Gas*, 320 U.S. at 602, the Court has preserved that methodology as a regulatory option. Thus, in *Duquesne*, the Court declined to adopt the historical cost approach as a constitutional requirement, observing that such a result would "foreclose a return to some form of the fair value rule just as its practical problems may be diminishing." 488 U.S. at 316 & n.10. What Verizon asks of the Court, however, is a policy-laden judicial determination that such "practical problems" do foreclose a regulatory agency's discretion to adopt a forward-looking cost regime.

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[36] Verizon cites the articles of commentators who support the incumbent LECs' challenge to TELRIC. For a sampling of the many articles on the other side of the issue, see Gabel & Rosenbaum, *supra*; Hovenkamp, *supra*; Chen, *supra*; William J. Baumol & Thomas W. Merrill, *Does The Constitution Require That We Kill The Competitive Goose? Pricing Local Phone Services To Rivals*, 73 N.Y.U. L. Rev. 1122 (1998); Jim Rossi, *The Irony Of Deregulatory Takings*, 77 Tex. L. Rev. 297 (1998); William J. Baumol & Thomas W. Merrill, *Deregulatory Takings, Breach Of The Regulatory Contract, And The Telecommunications Act of 1996*, 72 N.Y.U. L. Rev. 1037 (1997).

As one commentator has observed, the incumbents seek "Smyth v. Ames reborn, only in reverse"—a decision foreclosing what, as embodied in TELRIC, "is arguably the fair value rule at its theoretical best, a system of setting rates 'according to the actual present value of [utility] assets' so that rate regulation can more effectively 'mimic[] the operation of the competitive market.'" Jim Chen, *The Second Coming of Smyth v. Ames*, 77 Tex. L. Rev. 1535, 1561 (1999) (quoting *Duquesne*, 488 U.S. at 308).

In few, if any, contexts would the methodological discretion of a regulatory agency merit greater judicial deference than in this one. See generally *Iowa Utils. Bd. I*, 525 U.S. at 397; *Chevron*, 467 U.S. at 842-843. The FCC, after considering various approaches to setting network element rates, including the forward-looking approach recently adopted by several States, chose such an approach as the means of determining "cost" in an industry undergoing the transition from monopoly to competition. See *Local Competition Order* (paras. 704-711), J.A. 397-403. The FCC observed that, in that regulatory setting, a market-based, forward-looking approach to cost offers a variety of theoretical advantages over a historical cost approach. See *Local Competition Order* (paras. 620, 705), J.A. 327-328, 398-399. The FCC concluded that those advantages outweigh concerns—which, the FCC found, are largely refuted by practical experience—that a forward-looking methodology would be more indeterminate than the alternatives. See, *e.g.*, *Local Competition Order* (para. 681), J.A. 381. That decision is reasonable; nothing in the 1996 Act precludes it; and any policy-based revision of that decision should come from the FCC or from Congress, not from the federal courts.[37]

[37] Verizon incorrectly suggests that the workability of TELRIC is called into question by the amount of time that the FCC took to develop a forward-looking cost model in the universal service context. Verizon Pet. Br. 45-46. Section 252 contemplates that each state public utility com-

Indeed, Verizon's expressions of concern about the "administrative workability" of TELRIC ring hollow because any historical cost methodology would present significant administrative difficulties of its own. A historical cost methodology, no less than other cost methodologies, requires complex judgment calls about an appropriate rate of depreciation, the cost of capital, and a method for allocating joint and common costs to various aspects of the network. See, *e.g.*, *National Rural Telecom Ass'n*, 988 F.2d at 178; see generally *Duquesne*, 488 U.S. at 314 ("[t]he economic judgments required in rate proceedings are often hopelessly complex"). Similarly, TELRIC's inquiry into efficient technological alternatives may not be "any more hypothetical in nature than the judgments called for [under a historical cost approach] in determining whether or not capital costs, some of which were incurred decades ago, were 'prudently' made or are 'used and useful.'" Gable & Rosenbaum, *supra*, 52 Fed. Comm. L. J. at 254. Moreover, historical cost data in the telecommunications industry have tended to focus on an incumbent's revenue needs in other contexts, not on the proper level of compensation to incumbents for the competitive use of particular facilities; as a result, those data have traditionally been aggregated over large geographic areas,

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mission will establish rates for network elements in its respective State. See 47 U.S.C. 252(c)(2). The state commissions have been doing so, using TELRIC or (during the period when the FCC's pricing rules were stayed or vacated) a similar methodology, for nearly five years. The alleged complexity of forward-looking cost methodologies thus has not proved a significant impediment to the state commissions' ability to carry out their responsibilities under the 1996 Act. In the universal service context, by contrast, the FCC has been given the task of administering a national program, which required the FCC itself to determine universal service subsidy levels for carriers in every State. See 47 U.S.C. 254(a)(2) and (e). Since the prospect of determining such subsidy levels through individualized proceedings was not practical for a single regulator, the FCC understandably devoted considerable time to developing a model that would eliminate the need for such proceedings.

typically covering the entire territory served by a single company within a State.[38] It could therefore be exceedingly difficult to use existing historical cost data to establish reliable historical cost figures for particular facilities, functions, or features that new entrants may seek to lease.

Finally, the theoretical and practical shortcomings of the historical cost approach were not well recognized when Justice Brandeis wrote his dissenting opinion supporting that approach in *Missouri ex rel. Southwestern Bell Telephone Co.* v. *Public Service Commission*, 262 U.S. 276, 289-311 (1923), an opinion on which Verizon places considerable emphasis. The ensuing 75 years of experience have revealed not just the substantial indeterminacy of historical cost methodologies, but also their tendency to produce inefficient overinvestment and misallocation of resources See, *e.g.*, *National Rural Telecom Ass'n*, 988 F.2d at 178; Harvey Averch & Leland L. Johnson, *Behavior Of The Firm Under Regulatory Constraint*, 52 Am. Econ. Rev. 1052 (1962); Jean-Jacques Laffont & Jean Tirole, *Competition In Telecommunications* 38 (2000). Moreover, Justice Brandeis was addressing the use of such methodologies in the context for which they were designed: determining a utility's overall revenue requirements. He did not address the use of such costs in the quite different context presented here: determining compensation levels for the competitive use going forward of particular network facilities, in circumstances where the legislature has endorsed such use in order to accelerate the transition from monopoly to competition.

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[38] See, *e.g.*, *In re Federal-State Joint Bd. on Universal Serv., Recommended Decision*, 12 F.C.C.R. 87, 230 (para. 270) (1996); *In re Federal-State Joint Bd. on Universal Serv., Report and Order*, 12 F.C.C.R. 8776, 8903 (para. 232) (1997).

CONCLUSION

The decision of the court of appeals should be affirmed insofar as it sustained the FCC's discretion to adopt a methodology based on forward-looking costs to determine the rates that incumbents are authorized to charge new entrants for interconnection and network elements.

Respectfully submitted.

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JUNE 2001